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## Corporate Governance

The corporation is the primary means of organizing large-scale economic production in modern capitalist societies. The governance of corporations—i.e., the allocation of rights and duties among shareholders, directors, and officers—is thus a subject of great practical significance to Members of Congress interested in economic policy. This In Focus provides a basic overview of U.S. corporate governance, focusing on the sources of corporate governance regulation, shareholder activism, and shareholder litigation.

### Agency Costs

In the typical large public corporation, ownership is separated from control. While shareholders, as “owners,” have a residual claim on a company’s cash flow, management authority resides in boards of directors, which delegate various powers to corporate officers. In the language of economics, the separation of corporate ownership and control produces “agency costs”—i.e., potential losses that may result from divergences between the interests of shareholders and managers. For example, corporate leaders may self-deal, engage in inefficient “empire building,” retain unnecessary levels of cash, seek high levels of performance-insensitive compensation, resist takeover offers that would benefit shareholders, exhibit greater risk aversion than diversified shareholders would prefer, and expend less effort than a sole owner. U.S. corporate governance has long focused on mitigating agency costs by attempting to align the interests of shareholders and managers.

### Sources of Corporate Governance Regulation

The governance of publicly traded firms is shaped by state corporate law, federal securities law, and stock exchange rules.

#### State Corporate Law

With limited exceptions, corporations are chartered at the state level. Corporations can organize themselves in any state, regardless of where they conduct their operations. In selecting a state in which to incorporate, managers also choose a particular body of corporate law. Under a choice-of-law rule known as the “internal affairs doctrine,” the relationships between and among a corporation and its officers, directors, and shareholders are governed by the law of the state in which the corporation is organized. Classic “internal affairs” include the fiduciary duties of directors and the basic allocation of powers between boards and shareholders.

Some scholars have posited that states compete for incorporations and the associated franchise tax revenue. That premise has led to debate over whether state charter

competition produces a “race to the bottom” in which management-friendly laws prevail or a “race to the top” in which markets induce managers to incorporate in states with efficient corporate law. In either case, the clear winner in the competition to attract large public companies has long been Delaware, which serves as the corporate home for roughly 65% of S&P 500 firms.

State corporate statutes vest managerial authority in boards of directors, with shareholders possessing narrowly circumscribed powers. As a general matter, shareholders have three primary rights: to vote on a limited range of matters (e.g., director elections and extraordinary transactions), sell their shares, and sue (e.g., to enforce fiduciary duties). These rights are subject to a variety of formal and practical restrictions, leading some to characterize U.S. corporate law as embodying a philosophy of “director primacy.”

#### Federal Securities Law

To the extent that states compete for corporate charters, that competition occurs within a federal system in which Congress possesses broad authority to regulate the governance of companies engaged in interstate commerce. In the eyes of some observers, the possibility of preemptive federal legislation has constrained the degree to which states may adopt corporate law rules that deviate from the preferences of federal lawmakers. Despite this latent power, federal authorities have enacted few measures that regulate substantive corporate governance directly. Examples include requirements that public companies conduct advisory shareholder votes on executive compensation and that certain board committees of exchange-listed firms consist entirely of directors who are independent from management. The bulk of federal securities law, however, concerns disclosure. The Securities and Exchange Commission (SEC)—which administers the securities laws—requires public companies to periodically disclose information regarding their financial performance, operations, and governance. The SEC’s proxy rules similarly mandate that public companies make certain disclosures when soliciting proxy votes for shareholder meetings.

While federal securities law is primarily disclosure-based, it influences substantive corporate governance in several ways. First, disclosure may assist shareholders in making informed decisions regarding their rights to vote, sell, and sue. Second, disclosure may affect the behavior of corporate leaders. For example, a requirement to disclose the terms of related-party transactions may deter problematic self-dealing. Third, disclosure may enhance the accuracy of stock prices, facilitating the operation of the market for corporate control and the effectiveness of

executive-compensation plans that seek to tie managerial pay to performance.

### Stock Exchange Rules

The leading stock exchanges—the New York Stock Exchange (NYSE) and Nasdaq—also influence corporate governance through their rules for listed companies. The NYSE and Nasdaq have adopted director independence requirements and rules for determining independence that are more stringent than those in federal law. The exchanges also require listed firms to obtain shareholder approval for many types of equity compensation plans and certain large share issuances.

### Shareholder Activism

State law gives corporations considerable freedom to adopt their own governance arrangements. For example, in most states, companies can adopt a staggered or unitary board structure, issue different classes of stock with different voting rights, and select among a range of voting standards for director elections. Because of this flexibility, many features of corporate governance emerge from interactions between boards and shareholders.

Shareholder activists—i.e., shareholders that seek to influence corporate behavior or governance—pursue several types of strategies. Activists seeking governance changes often rely on SEC Rule 14a-8, which requires public companies to include shareholder proposals in their proxy materials, provided certain conditions are met. While most shareholder proposals are nonbinding recommendations, companies often implement proposals that receive significant support. For example, shareholder proposals have prompted many companies to remove takeover defenses and adopt majority voting for director elections.

Other shareholder activists seek changes in a firm's operational or financial strategy. Activist hedge funds are the most prominent investors in this category. The activist fund playbook typically begins with the acquisition of a sizeable but noncontrolling stake (usually between 5% and 10%) in a public company. Activists then present management with strategic proposals, such as operational changes, increased dividends or stock buybacks, the sale of underperforming assets, or the sale of the entire company. If management resists a fund's proposals, the fund may threaten and ultimately initiate a proxy contest seeking board representation.

The role of activist funds in corporate governance is controversial. Some commentators contend that activist investors play a valuable role in mitigating managerial agency costs, while others argue that hedge funds pursue short-term profits at the expense of long-term shareholders and other corporate constituencies, such as employees and creditors.

The primary policy lever affecting hedge fund activism is Section 13(d) of the Securities Exchange Act, which requires persons that acquire beneficial ownership of more than 5% of a public company's shares to disclose their positions within ten calendar days or such shorter time as

the SEC may establish by rule. In 2023, the SEC narrowed the 13(d) disclosure window from ten calendar days to five business days, shortening the period within which hedge funds can acquire shares at pre-disclosure prices.

### Shareholder Litigation

Shareholder lawsuits against companies, directors, and officers play a central role in corporate governance. There are two principal categories of shareholder lawsuits: state law fiduciary duty litigation and federal securities fraud claims.

Under state law, directors owe fiduciary duties of care and loyalty to the corporation and its shareholders. In analyzing whether directors have breached those duties, Delaware courts apply different standards of review based on the context. Delaware has three general tiers of review: the business judgment rule (BJR), enhanced scrutiny, and entire fairness. The BJR is the default standard of review. It provides strong deference to informed, good-faith decisions made by unconflicted directors. Absent proof that the board failed to satisfy one of those criteria, Delaware courts evaluate only whether a challenged decision was rational. Enhanced scrutiny applies in certain scenarios that raise concerns about director motives even where directors are formally disinterested and independent—for example, takeover defenses and sales of control. In these circumstances, Delaware courts employ standards designed to assess whether directors were pursuing legitimate goals through reasonable means. The entire fairness test is Delaware's most onerous standard of review and applies to conflict-of-interest transactions lacking certain procedural protections. Under the entire fairness test, defendants must prove that a challenged transaction was the product of both fair dealing and fair price.

Federal securities fraud claims generally allege that a company and/or its managers made fraudulent statements or omissions that affected the price of the company's stock. Many securities fraud lawsuits are brought as class actions under SEC Rule 10b-5, which prohibits material misstatements and omissions in connection with the purchase or sale of any security. While securities litigation concerns misleading disclosures, it functionally regulates a broad swath of corporate behavior, as managers engaged in misconduct often do not disclose their malfeasance. As a result, a wide range of alleged improprieties may trigger fraud claims.

Commentators have debated the value of shareholder litigation as a governance device. Those who view shareholder litigation favorably appeal to its role in securing compensation for injured shareholders and deterring misconduct. Skeptics argue that much shareholder litigation is driven by attorneys with interests that diverge from those of shareholders. The compensatory justification for securities litigation has also fallen out of favor among academics, many of whom contend that a significant number of shareholders effectively fund their own recoveries when corporations settle fraud claims.

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